> service estimates calculated by the forward-looking economic cost models that we will be evaluating further in the FNPRM. Revenues from services in addition to the supported services should, and do, contribute to the joint and common costs they share with supported services. Moreover, the former services also use the same facilities as the supported services, and it is often impractical, if not impossible, to allocate the costs of facilities between the supported services and other services. For example, the same switch is used to provide both supported services and discretionary services.[17]

V. CONSISTENCY IN ESTIMATING THE NEED FOR SUPPORT

If the FCC starts with this sound economic, legal, and public policy basis for implementing its universal service policy, it should be possible to develop a reasonably sized fund that accomplishes the goals of the Act without creating substantial pressures to increase basic rates. Implementation must be consistent with the principles cited above and the FCC's authority.

Several of the large, non-rural LECs would not only have the FCC abandon the sound legal and economic basis on which it has launched its 1996 Act universal service policy, but they would also have the FCC misapply its methodology. In particular, they urge that the FCC to allow universal service support to be calculated on the basis of a radically different view of the network than the one used for calculation of unbundled network elements. OPC believes that the FCC should apply a consistent view of the network that reflects its economic nature.

A. MATCHING COSTS AND SUPPORT

Upon the completion of the transition, the forward-looking economic costs and the sum of the unbundled network elements should be equal. The whole should equal the

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17 FCC, Universal Service Order, para. 261.

sum of the parts in this cost analysis. Failure to achieve this equality would either allow the incumbent to over-recover costs (if UNEs exceed costs) or entrants to be the recipient of the implicit subsidies (if forward-looking efficient costs exceed UNEs). As long as the costs are forward-looking and efficient, they should be the basis for both UNEs and universal service calculations.

With the efficient forward-looking costs identified, the principle should be that the subsidy goes with the responsibility to maintain the underlying facilities. If the unbundled element is priced at its full cost (as calculated with a forward-looking, most efficient methodology) then the purchaser of the UNE should get the subsidy. If the UNE is not priced at its full cost, then the subsidy should stay with the entity selling the UNE. If the subsidy goes to the seller of the UNE and it is priced at its full cost, there would be a double recovery.

B. MATCHING UNE AND USF AREAS

The unit of analysis should be consistent across analyses. That is, if UNEs are offered over a specific area, e.g. urban areas, then USF should be estimated over the same area. Failure to use a consistent unit of analysis will create opportunities for over-recovery of costs and will impede competition. If the USF is calculated on an exchange-by-exchange basis, but UNE prices are calculated on a larger unit of analysis, companies will receive support for loops whose costs are below the cost-based UNE rate.[18]

The FCC has recognized the need for consistency, in general, and the fact that USF areas should be consistent with UNE areas, in particular, in its initial decision.

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18 GTE's (attachment 1) effort to address the problem of a mismatch between UNE areas and USF areas involves regulation of competitors' rates.

> We also encourage a state, to the extent possible and consistent with the above criteria, to use its ongoing proceedings to develop permanent unbundled network element prices as a basis for its universal service cost study. This would reduce duplication and diminish arbitrage opportunities that might arise from inconsistencies between the methodologies for setting unbundled network element prices and for determining universal service support levels. In particular, we wish to avoid situations in which, because of different methodologies used for pricing unbundled network elements and determining universal service support, a carrier could receive support for the provision of universal service that differs from the rate it pays to acquire access to unbundled network elements needed to provide universal service. Consequently, to prevent differences between the pricing of unbundled network element and the determination of universal service support, we urge states to coordinate the development of cost studies for the pricing of unbundled network elements and the determination of universal service support.[19]

The FCC has not shown that it is planning to implement the federal universal service fund on this basis. At the time of the initial order, the Commission did not have much information about how UNEs would be defined. The majority of states have now acted on UNEs and the Commission can now run its cost models at levels of disaggregation consistent with UNE zones. This is how the states have defined the telecommunications market and it is entirely consistent for the Commission to adopt these areas in calculating universal service support.

C. MATCHING ANALYSIS WITH ACTUAL ECONOMIC BEHAVIOR

The Commission should reject the choice of the Census Block Group (CBG) as the unit of analysis. Although the FCC seeks a smaller unit of analysis than the current study area and identifies census block groups as one possible unit of analysis, the census block group does not drive the network architecture, nor are telecommunications services

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19 FCC, Universal Service Order, para. 251.

marketed at this level. In determining the unit of analysis, the key point is the efficient targeting of support and a reasonable representation of economic behavior in the deployment of facilities and the marketing of services. The census block group does not represent a market segmentation that is reasonable for a new entrant. It is virtually impossible to deploy facilities, to advertise, and offer service by census block groups. The economic unit on both the supply-side and demand-side is larger.

Choosing an excessively small unit of analysis creates an unnecessarily large universal service fund, since it eliminates the actual averaging of costs that inevitably goes on in the marketplace. Virtually no producers of goods and services price discriminate down to the census block level, when there are joint and common costs and economies of scale and scope in production.

The issue is not simply one of targeting subsidy payments, but getting the costs right. If a very granular unit of analysis is used, economies of scale and scope are underestimated. As a result, support payments will be overestimated. Recent testimony of Ameritech in a universal service proceeding in Indiana has argued exactly this point.

> Ameritech Indiana proposes that the exchange, as defined by the ILEC's current exchange boundaries, should be used to define a service area for a high-cost subsidy program. Such a definition strikes a balance between an overly large area (such as a statewide study area or even a LATA) and an overly small area such as a CBG. Using CBGs as a service area would be administratively burdensome and would not comport to real world areas in which telecommunications companies seek to offer service.
>
> Defining a service area in as granular level as a CBG has no bearing on competition since it is unlikely that an ALEC or an ILEC would make its competitive entry plans on the basis of a CBG. . . . Further, the size of the service area will not adversely affect the capital requirements of an ALEC because an ALEC can always use the resale alternative to meet its universal service obligation in a service area. The interconnection, unbundling, and resale provisions of TA96 ensure that the scale economies of the ILEC are available to the ALEC. Therefore, there's no

> more capital strain on ALECs to serve a given service area than there is on ILECs.
>
> CBGs obviously do not correspond to how the telecommunications network is presently laid out, or how ALECs are likely to build their own networks. CBGs do not correspond to how telecommunications services are marketed to market segments.[20]

Although Southwestern Bell supports the use of CBGs for purposes of USF payments (even though it has not significantly deaveraged its UNEs), it does admit that CBGs have nothing to do with the way the network was deployed.

> In order to receive support for a line an ETP [Eligible Telecommunication Provider] will need to identify the CBG in which the customer is located. No smaller geographic area is appropriate for support distribution. The CBG is a geographic area that has previously been totally unrelated to the local exchange telephone business and consequently does not exist in telephone company records.[21]

VI. THE FCC SHOULD REJECT EFFORTS TO IMPROPERLY RESTRICT UNIVERSAL SERVICE

A number of commentors have recommended that the FCC restrict the availability of universal service support in ways that exceed its authority or violate the intention of the Act. The FCC should reject these recommendations.

A. THE FCC SHOULD NOT, AND LEGALLY CANNOT, IMPOSE AN OBLIGATION TO SERVE

The incumbent LECS and several other parties have recommended a variety of other policies which have little to do with promoting universal service and a lot to do

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20 Rebuttal Testimony of Bruce A. Hazzlet on Behalf of Ameritech-Indiana, In re Investigation, on the Commission's Own Motion, Into Any and All Matters Relating to Access Charge Reform and Universal Service, including, but not Limited to, High-Cost or Universal Service Funding Mechanisms Relative to Telephone and Telecommunications Services Within the State of Indiana, pursuant to IC 8-1-2-51, -58, -59, -69; 8-1-2-2.6 et seq., and Other Related Statutes, as Well as the Telecommunications Act of 1996 (47 U.S.C. §151 et. seq.), Cause No. 40785.

with protecting monopoly positions or securing competitive advantage. For example, GTE would have the FCC impose an obligation to serve on CLECs.[22] US West supports the use of universal service funds for line extensions.[23]

OPC believes that the FCC has already exceeded its authority by infringing on the state's authority to determine eligibility of telecommunications carriers. Adding an obligation to serve would only make matters worse and drive the FCC even farther beyond the limits of its statutory authority. Moreover, at present there is no economic or legal basis to alter the obligation to serve that has been in place in most states. The incumbent has had and continues to have the obligation to serve all. It is the carrier of last resort (COLR). The incumbent has ubiquitous facilities. The obligation to serve is a "burden" placed on the incumbents that is compensated by historical and ongoing benefits of immense value.

The incumbents have deployed those facilities with significant benefits from ratepayers, including a monopoly position and regulatory rights to an opportunity to recover costs. The pervasive market presence and longstanding name recognition conferred on the incumbent also endow it with substantial assets as competition increases in the industry. Incumbents are directly compensated by setting rates that are, in the

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21 Reply Comments of Southwestern Bell Telephone Company, Texas Public Utility Commission, Project 14929, p. 27, October 10, 1997.

22 GTE argues as follows (p.13):

> CLECs should be free to price, package, and target their offerings, but in order to receive universal service funding they should be required to take on an obligation to serve. This obligation should be defined so as to prevent the CLEC from serving selectively only the customers it wishes, and receiving support for doing so . . . . To help achieve the competitive neutrality for universal service that the Commission has embraced, all carriers receiving universal service support should undertake symetric obligations in return for the same payment per customer in a given area.

23 US West, p. 4, citing a recommendation of the Arizona Corporation Commission.

aggregate, just and reasonable. They are also provided an opportunity to recovery prudently incurred used and useful costs. New entrants have no such opportunity. Moreover, indirectly, the benefits of the monopoly, incumbent ubiquitous network compensate the incumbent.

Given the current market structure, with virtually no change in market share and no observable price competition the obligation to serve falls fairly on the incumbent. At some point in the future, when competition has balanced revenue opportunities and new entrants have facilities deployed that could shoulder the obligation to serve, alternative approaches may be necessary, but these decisions should rest entirely with the state.

B. RESTRICTIONS ON THE TYPE OF SERVICE HAVE NO PLACE IN THE HIGH COST/UNIVERSAL SERVICE ANALYSIS

The Commission cannot, as a matter of law, nor should it as a matter of public policy, restrict high cost support to primary lines. As a matter of law, the Act seeks to ensure that reasonably comparable services are available at reasonably comparable rates and to promote use of the telecommunications network for advanced services.

> §254(b)(3). Access in rural and high cost areas – Consumers in all regions of the Nation, including low-income consumers and those in rural, insular, and high cost areas, should have access to telecommunications and information services, including interexchange services and advanced telecommunication and information services, that are reasonably comparable to those services provided in urban areas that are available at rates that are reasonably comparable to rates charged for similar services in urban areas.

To discriminate against residential and small business customers in rural areas by requiring them to pay a much higher price for second lines than their urban brethren is directly contrary to the goal of reasonably comparable services at reasonably comparable

rates. To the extent that second lines have become associated with use of information services, rural households would be severely discriminated against.

Even if the statute could be interpreted to suggest that the universal service language in the Act covers only primary lines, attempting to determine which line is a primary line and which is a secondary line presents an administrative nightmare. Multi-family households would be required to share lines. Large families would be at a disadvantage compared to small. Married couples would pay more than unmarried partners would. Recent testimony by GTE in Hawaii makes a number of points similar to these observations.[24]

C. INCOME RESTRICTIONS HAVE NO PLACE IN THE HIGH COST/UNIVERSAL SERVICE ANALYSIS

Proposals to target high cost support to specific inhabitants of a high cost area based on their income or other characteristics miss the entire point of the high cost fund based on a standard of reasonably comparable rates. Congress mandated a simple and direct comparison of rates in specific areas. It did not condition this comparison on income or any other characteristics.[25] Affordability is a separate matter, not mentioned in the high cost section of the Act.

Universal service is supposed to be a simple concept of including all. The means-tested view of high cost turns it into a witch-hunt -- a search for those who are "able to

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24 Rebuttal Testimony and Exhibits of Dennis Weller Chief Economist, GTE Hawaiian Telephone Co. Inc. Subject: Universal Service Fund, In the Matter of Public Utilities Commission Instituting a Proceeding on Communications, Including an Investigation of the Communications Infrastructure of the State of Hawaii, Docket No. 7702.

25 Ameritech – Indiana, for example, has proposed that a comparison be made between price/cost margins, rather than rates.

pay." Companies who have steadfastly resisted using the telecommunications network for social policy suddenly want to means test the price of service.

- Middle income consumers in high cost areas will pay more for telephone service because they do not deserve a subsidy.
- Small businesses will pay more because they can pass the cost through to consumers.
- A household will pay ten times as much for the second line as it did for the first, because universal service will not apply to the second line. Urban consumers will get a second line for connection to the Internet at $10, while rural customers will pay $150. The information superhighway will be readily available and cheap in urban areas and unaffordable in the countryside.

This is the antithesis of universal service policy and it clearly conflicts with policy in the statute that requires rates to be comparable. In fact, reasonable comparability of rates is the ceiling on rates in high cost areas. To the extent that affordability could enter into the analysis of rates in high cost areas, it would have to be invoked to lower the price charged in the area, not raise it.

VII. CONCLUSION

OPC respectively suggests that applying the above principles will result in a federal universal service fund that is within the statutory authority of the Commission. These principles effectively accomplish the goals set out by Congress without creating an unnecessarily large fund. They do not place upward pressure on basic service rates in the states.

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Respectfully submitted

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